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U.S.-China Economic and Security Review Commission

Monthly Summary of U.S.-China Trade Data **December 4, 2013**

Highlights of this month's edition

- **Bilateral trade:** Surge in U.S. exports in October, but year-to-date deficit remains high; agricultural exports lead but U.S. technology-intensive industries also benefit
- **Bilateral policy issues:** China-EU summit in Beijing leads to talk of BIT and FTA; WTO ITA Talks fall through; Biden and Lew visit Asia, address Shanghai FTZ and criticize ADIZ
- **Sector spotlight:** Pharmaceuticals sector in China seeing rapid growth; may benefit from 3rd Plenum; questions regarding future competitiveness against European and U.S. firms
- **China's economy:** Growth likely to meet government target; capital inflows up despite flagging exports; continual risks in banking sector and housing market

Substantial Increase in U.S. Exports to China in November

U.S. exports to China shot up in October, rising 36 percent month-on-month and 21 percent year-on-year. Although October tends to be a strong export month, due to the harvest of U.S. agricultural crops that are exported to China, the increase so far this year was higher than in 2011 and 2012 (see figure 1). At $13 billion, it was by far the highest monthly export value on record, and the biggest jump since the mid-1990s. At the same time, U.S. imports from China barely increased. Taken together, these developments helped to slow the increase in the U.S. trade deficit with China. In 2011-2012, the deficit rose by $16.1 billion through the first 10 months; this year, it rose by only $5.4 billion. Even so, at $267 billion, the U.S. trade deficit with China has accounted for 46 percent of the U.S. trade deficit with the world this year.

Figure 1: Growth of U.S. Trade with China through October 2013
(monthly, year-on-year, %)

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, December 2013). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

Top Exports and Imports

Agricultural goods accounted for a quarter of U.S. exports to China in October, due to seasonal factors. More surprising, however, was the strong growth in other U.S. exports. Transport equipment, the one non-agricultural sector in which the United States enjoys a large trade surplus with China, saw 59 percent year-on-year growth in October, and has been the leading export so far this year. Computer and electronic products, chemicals, and machinery also performed well. Conversely, imports of computer and electronic products, which account for nearly two-fifths of U.S. imports from China, declined by 0.8 percent (see figure 2).

Figure 2: Top Exports and Imports through October 2013
(in US$ millions)

U.S. Top-Five Exports to China

	Exports	Share of total (%)	Change over Oct'12 (%)
Monthly (October 2013)			
Agricultural Products	3,557.0	27%	8.7%
Transportation Equipment	2,235.5	17%	58.7%
Computer and Electronic Products	1,446.0	11%	25.5%
Chemicals	1,309.6	10%	33.8%
Machinery, Except Electrical	802.5	6%	1.0%
Other	3,709.3	28.4%	
Total	**13,060.0**	**100.0%**	
Year-to-date (thru October 2013)			
Transportation Equipment	18,738.1	19.6%	
Computer and Electronic Products	13,295.8	13.9%	
Agricultural Products	12,042.1	12.6%	
Chemicals	10,995.8	11.5%	
Machinery, Except Electrical	8,207.7	8.6%	
Other	32,474.9	33.9%	
Total	**95,754.5**	**100.0%**	

U.S. Top-Five Imports from China

	Imports	Share of total (%)	Change over Oct'12 (%)
Monthly (October 2013)			
Computer and Electronic Products	15,259.9	36.4%	-0.8%
Miscellaneous Manufactured Commodities	4,801.7	11.5%	14.2%
Electrical Equipment, Appliances, and Component	3,393.8	8.1%	15.1%
Apparel and Accessories	3,388.3	8.1%	1.7%
Leather and Allied Products	2,204.9	5.3%	-1.8%
Other	12,872.9	30.7%	
Total	**41,921.5**	**100.0%**	
Year-to-date (thru October 2013)			
Computer and Electronic Products	130,541.8	36.0%	
Miscellaneous Manufactured Commodities	29,892.4	8.2%	
Electrical Equipment, Appliances, and Component	28,141.3	7.8%	
Apparel and Accessories	28,087.7	7.7%	
Leather and Allied Products	21,109.4	5.8%	
Other	124,994.2	34.5%	
Total	**362,766.9**	**100.0%**	

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, December 2013). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

Advanced Technology Products

Relative to 2012, U.S. advanced technology products have performed better this year than last year (see figure 3). In the two sectors with the largest deficits, opto-electronics and information & communications, there has not been significant year-on-year growth in the deficit. More importantly, the U.S. trade surplus has increased substantially in electronics, flexible manufacturing, and aerospace.

Figure 3: U.S.-China Trade in Advanced Technology Products
(in US$ millions)

	Monthly			Cumulative year-to-date			
	Exports	Imports	Balance Oct'13	Exports	Imports	YTD Balance Oct'13	YTD Balance Oct'12
TOTAL	**2,599**	**13,645**	**-11,046**	**23,595**	**116,639**	**-93,044**	**-94,508**
(01) Biotechnology	27	8	19	326	64	262	180
(02) Life Science	261	159	102	2,453	1,687	766	592
(03) Opto-Electronics	23	617	-594	268	4,207	-3,939	-5,681
(04) Information & Communications	406	12,345	-11,939	3,752	105,951	-102,199	-97,597
(05) Electronics	547	327	220	4,052	2,815	1,237	770
(06) Flexible Manufacturing	119	78	41	2,106	779	1,327	1,085
(07) Advanced Materials	10	20	-10	158	203	-45	71
(08) Aerospace	1,203	74	1,129	10,247	662	9,585	6,225
(09) Weapons	0	18	-18	1	132	-131	-133
(10) Nuclear Technology	3	0	3	232	140	92	-18

Source: U.S. Census Bureau, NAICS database (Washington, DC: U.S. Department of Commerce, Foreign Trade Division, December 2013). http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

Bilateral Policy Issues

Information Technology Agreement Expansion Talks Suspended Again

Negotiations in Geneva to expand the coverage of the Information Technology Agreement were suspended on November 21 for the second time this year.[*] The main reason was China's refusal to accept tariff cuts to an extent that is viewed as commercially meaningful by other participants. China is one of 20 WTO members, along with the United States and the 28-nation European Union, that have been negotiating to expand the 1996 Information Technology Agreement (ITA) to eliminate tariffs on new generation technology products.[1]

The WTO talks to expand the ITA were suspended in July this year over China's tough line, but were restarted after senior Chinese officials signaled in October they were willing to offer more concessions.[2] The revised Chinese offer, however, was only a slight improvement on one it submitted previously, and was rejected by other participants as insufficient.

In its latest offer, China said it could not accept tariff cuts on nearly 60 of the 250 products that other participants in the ITA expansion talks have proposed for duty elimination. For another 80 products, China said it would only be willing to phase out duties over a period of five years or more.[3] These demands are problematic for several reasons. For example, China would not accept tariff cuts on a class of advanced semiconductors known as MCOs and flat-panel displays—products important to other participants. Further, China's demand that duties for some products be phased out over a lengthy period would undermine the value of a tariff-cutting agreement.[4]

Although other countries participating in the talks, such as Malaysia, Thailand, and Costa Rica, expressed reservations, China's intransigence derailed the efforts to reach a commercially meaningful outcome before the December 3-6 WTO ministerial meeting in Bali,

[*] For information on the July talks, see our August 2013 bulletin. http://origin.www.uscc.gov/sites/default/files/trade_bulletins/August%20Trade%20Bulletin%208%2026%2013.pdf.

Indonesia. As China sought to deflect blame (for example, criticizing the United States for ignoring "the appeals of Chinese enterprises"),[5] U.S. Trade Representative Michael Froman publicly criticized China's stance, while the European Union Trade Commissioner Karel De Gucht urged China to be flexible in accepting tariff cuts on more of the items under negotiation.[6] At the time of this writing, no dates have been announced for resuming the talks.

Biden and Lew Travel to China, Part of Broader Asia Engagement

Vice President Joe Biden will be in Beijing December 4-5, 2013 as part of a larger Asia trip, with stops in Tokyo and Seoul. Vice President Biden will meet with Chinese President Xi Jinping, Premier Li Keqiang and Vice President Li Yuanchao to discuss a wide range of topics related to the U.S.-China relationship and regional issues.[7] The recent Chinese decision to create an air defense identification zone (ADIZ) in the East China Sea will feature in the discussion.[†] China's creation of the ADIZ, part of the broader escalation of tensions with Japan over the Senkaku Islands, has been met with widespread criticism from its neighbors and from the United States.[8] Speaking in Tokyo, his first stop during the trip, Vice President Biden condemned China's actions, saying the United States was "deeply concerned by the attempt to unilaterally change the status quo in the East China Sea," and promising that he would raise the issue when he meets President Xi.[9]

Vice President Biden's visit follows Treasury Secretary Jack Lew's November 10-15 trip to Asia which focused on the objectives of the Trans-Pacific Partnership (TPP). Secretary Lew discussed China's progress on the reform agenda and efforts to level the playing field for U.S. companies.[10] Secretary Lew, whose visit came at the conclusion of the Third Plenum,[11] said he had the impression that China was "very serious" about economic reform, but that "the sequence or the pace of the change" remained unclear.[12]

Secretary Lew said the evolving Shanghai free trade zone (FTZ) would demonstrate how serious China is in its plans to implement reforms.[13] The Chinese government has been promoting the Shanghai FTZ as a base for experiments with broad liberalization policies, though it did not provide details on specific policies or timetables for implementation. The People's Bank of China (PBoC), the central bank, said it would allow foreign investors and banks to invest in Shanghai's securities market, and permit Chinese investors in the FTZ to invest in overseas securities.[14] The investment restrictions will remain unchanged outside the Shanghai FTZ. In addition, the PBoC said foreign financial institutions in the FTZ will be allowed to borrow renminbi (RMB) overseas (outside the FTZ, foreign banks are limited in how much they can borrow from overseas to lend domestically).[15] The PBoC promised to provide a timetable and detailed regulations.

China-EU Summit in Beijing: Talk of a Bilateral Investment Treaty

In late November, top officials from the European Union and China held their annual summit in Beijing. The most significant outcome was an agreement to negotiate a bilateral investment treaty (BIT). A BIT, according to its lead negotiators – Chinese Premier Li Keqiang, European Council President Herman Van Rompuy, and European Commission President José Manuel Barroso – would help increase bilateral trade and investment. Although European foreign direct investment (FDI) is increasing, China accounts for just 2 to 4 percent of Europe's outbound investment, and China accounts for less than 1 per cent

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[†] Announced on November 23, 2013, China's ADIZ in the East China Sea includes the Japanese-controlled Senkaku Islands (known as Diaoyu in China), whose ownership China disputes; it also includes Socotra Rock, which is claimed by South Korea. See Xinhua, "Statement by the Government of the People's Republic of China on Establishing the East China Sea Air Defense Identification Zone," November 23, 2013.

of the total of foreign investment to Europe. The leaders pledged that bilateral trade would nearly double by 2020, from about $580 billion to $1 trillion.[16] European Union Trade Commissioner Karel De Gucht intimated as well that China and the EU could sign a free trade agreement "within the next ten years or so".[17]

Europe may also be pursuing the BIT as a confidence building measure after a spate of trade disputes with China this year. The worst of these concerned the European Commission's (EC) proposal to impose antidumping duties on imports of Chinese solar PV panels, which reached $29 billion in 2011. In late July, the two sides agreed instead to set a minimum price and volume limit on China's solar panels exports to the EU. On December 2, just days after the China-EU Summit, EU countries officially approved the settlement.[18]

The decision to launch BIT talks with the EU also comes just months after China reinitiated its BIT negotiations with the United States at the Strategic & Economic Dialogue talks. Beijing appears keen to provide its companies with the same legal protections, and this has been reinforced with recent actions by Chinese investors seeking investor/state dispute resolution. A complicating feature is that, unlike the United States, the EU consists of many members; China has already signed BITs with 25 EU countries, including Germany and France (see figure 4). The latest BIT with an EU country was signed eight years ago. If a BIT is eventually signed that affords the same rights to Chinese investors across all 28 EU countries, an important question is whether the China-EU Bit will supersede previous agreements with individual member states, particularly those agreements that predate China's newest model BIT (1998).

Figure 4: China's BITs with EU28 Countries

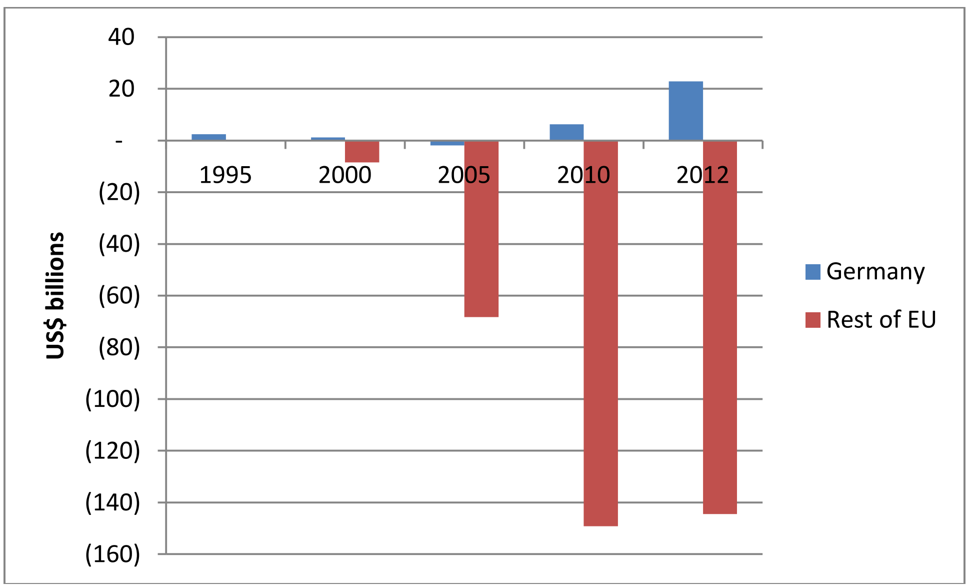
Date		Country	Date		Country
Signature	**Enactment**		**Signature**	**Enactment**	
2/21/2005	3/31/2005	Malta	11/25/1997	7/31/2000	Netherlands
1/26/2005	4/12/2006	Switzerland	3/30/1990	2/28/1993	Iceland
11/25/2003	8/19/2006	France	11/7/1989	5/31/1990	Lithuania
4/15/2003	8/31/2005	Romania	9/1/1989	5/31/1990	Estonia
12/8/2001	7/25/2004	Portugal	6/24/1988	12/20/1989	Greece
12/6/2001	5/24/2003	Slovakia	5/28/1987	3/31/1989	Hungary
11/13/2001	6/30/2004	Spain	6/6/1984	1/7/1985	Poland
6/5/2001	11/30/2005	Belgium/ Luxemburg	5/14/1982	5/14/1982	United Kingdom
11/14/2000	11/14/2002	Finland	9/11/1981	10/10/1982	Austria
9/26/2000	--	Sweden	4/28/1981	4/28/1981	Denmark
4/14/2000	1/31/2002	Latvia	1/27/1981	8/27/1983	Italy
11/30/1999	11/10/2001	Germany	11/20/1980	7/9/1981	Norway

Source: UNCTAD.

At the conclusion of the summit, EU Trade Commissioner De Gucht was adamant that Europe needs to "speak with one voice" in dealing with China. Quoted in the *Frankfurter Allgemeine Zeitung* (FAZ), a German daily, he criticized the divided response of European countries to the EC's proposed duties on Chinese solar panels earlier this year. Commissioner De Gucht made particular reference to Germany's Economics Minister Philipp Roesler (now voted out of office), who publicly sided with the Chinese in the dispute.[19] Roesler was likely influenced by Premier Li, who traveled to Berlin and other European capitals at the time to lobby against the duties (see USCC June Trade Bulletin). China appears to be maintaining these tactics now – Premier Li is scheduled to meet with central and eastern European heads of government in early December, in what one European diplomat described as a "'divide and conquer' strategy that seems calculated to put pressure on Brussels at a time when there are several ongoing trade disputes." [20]

De Gucht argued at the China-EU summit that China is more dependent on the EU than the other way around. The EU, when taken as a whole, has an economy three times the size of China's, and China has come to rely heavily on EU technology.[21] Nonetheless, Germany Economics Minister Roesler's actions in regard to the solar dispute were representative of the disparities in influence among European countries. Germany is the only major economy in Europe that enjoys a bilateral trade surplus with China. The surplus has grown particularly over the last three years (see figure 5). Whereas Germany accounts for 26.5 percent of EU exports to the world, it accounts for 40 percent of EU exports to China (see figure 6). In contrast to the EU's overall GDP, which declined from $14.3 trillion to $14.2 trillion in 2008-2012,[‡] Germany has achieved steady growth and increased its share of EU GDP to 20.1 percent. Trade has been integral to Germany's growth model. In the 12 months up to September 2013, Germany's current account surplus stood at $247.7 billion; without Germany, the Euro area balance was a paltry $3.4 billion.[22]

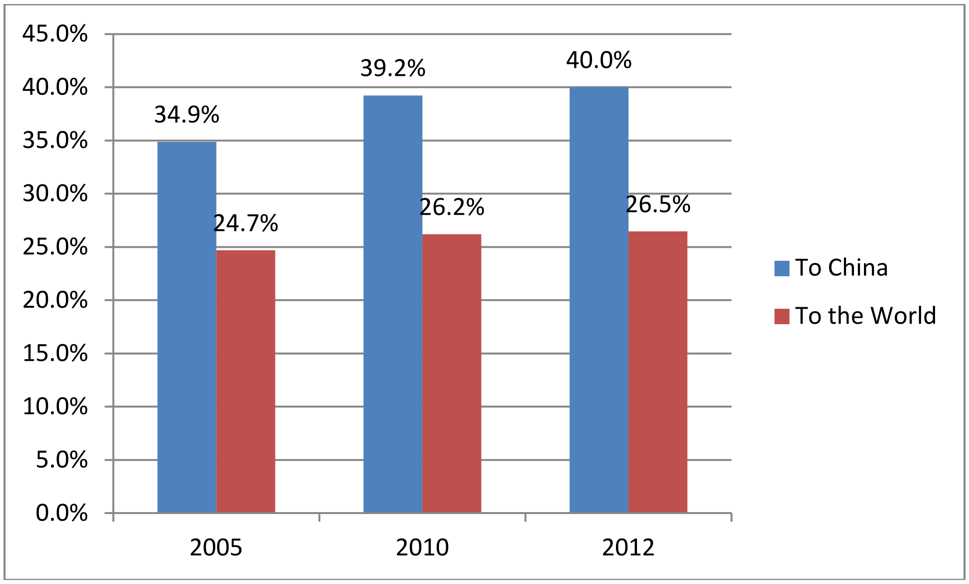
Figure 5: Trade Balance with China: Germany vs. Rest of EU
(US$ billions)



Source: China General Administration of Customs, via CEIC data.

[‡] GDP measured here in purchasing power parity terms, 2005 dollars. Numbers from International Monetary Fund, Balance of Payments Statistics Yearbook and data files, via World Bank.

Figure 6: Germany Share of EU Exports: To China vs. to the World
(Share, %)



Source: International Monetary Fund, Balance of Payments Statistics Yearbook and data files, via World Bank; China General Administration of Customs, via CEIC data.

Sector Spotlight: Pharmaceuticals

While China's pharmaceutical industry is small compared to that of the United States, it is now the world's third-largest, and is growing at over 20 percent per year (see figure 7). Pharmaceuticals are an important part of China's booming chemical industry, and enjoy export tax rebates. While U.S. imports of finished pharmaceutical goods from China remain small, the United States imported $6.3 billion worth of organic chemicals from China in 2012, vaulting China from 12th to 2nd among U.S. trade partners in this category. Many of these chemicals are used as intermediate inputs in pharmaceuticals; for instance, China is the United States' leading source of imports for antibiotics and vitamin derivatives.

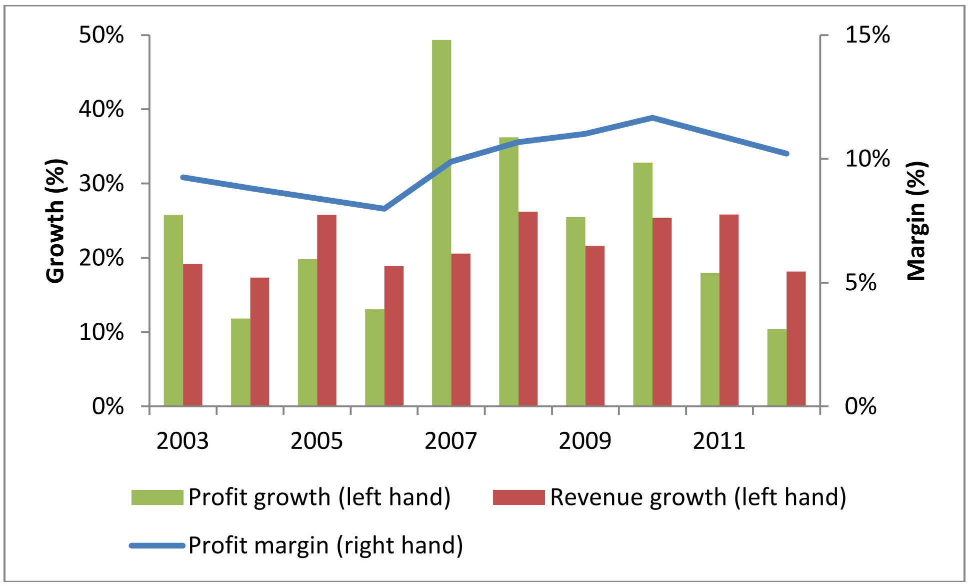
Figure 7: Pharmaceutical Industry Size by Country

	2009			**2011**		
Country	Rank	Market ($mn)	Growth (%)	Rank	Market ($mn)	Growth (%)
United States	1	301,095	6	1	322,290	3
Japan	2	89,865	17	2	111,642	16
China	3	45,261	24	3	66,805	22
Germany	4	41,287	-2	4	44,916	7
France	5	40,452	-5	5	41,197	6
Brazil	10	17,629	8	6	28,465	23
Italy	6	27,085	-1	7	28,357	7
Spain	7	22,722	1	8	22,679	2
Canada	9	19,143	0	9	22,294	3
United Kingdom	8	19,830	-11	10	21,564	6

Source: ABPI. *http://www.abpi.org.uk/*

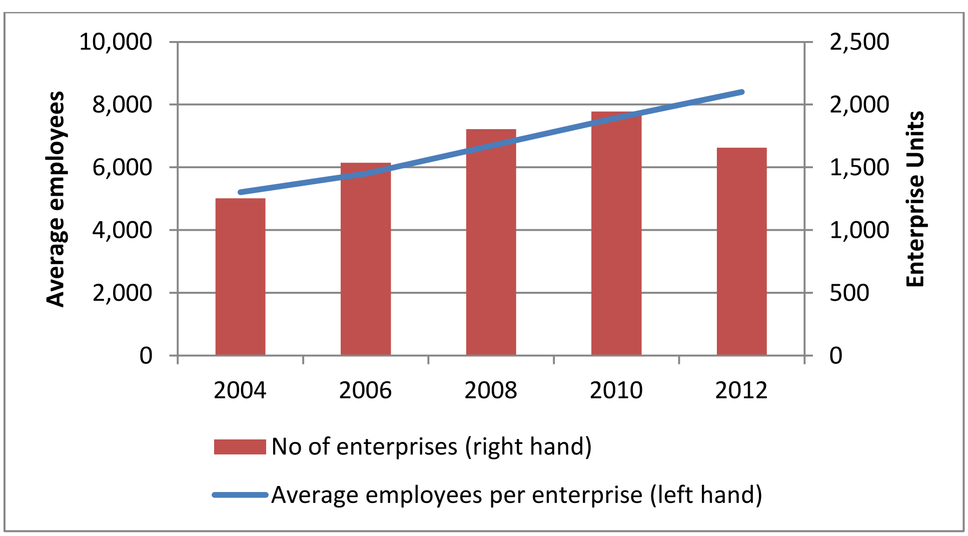
China has been less successful in promoting production of pharmaceuticals, which is part of a broader impetus in China's economic policy to produce higher value-added, technology-intensive products. In spite of rapid growth in recent years, China's pharmaceutical companies appear to be struggling. In the last two years, their profit growth has not kept pace with revenues (see figure 8). That has further depressed already low profit margins, which hover around 10 percent. By comparison, the U.S. pharmaceutical industry achieved profit margins of nearly 20 percent in 2008, ranking it third among U.S. industries.[23] Industry consolidation does appear to be progressing in China, giving rise to larger companies that can compete globally (see figure 9).

Figure 8: Pharmaceutical Industry in China: Growth of Profits and Revenues; Profit Margin
(Annual, year-on-year, %; margin, %)



Source: China National Bureau of Statistics & YYTJ, via CEIC data.

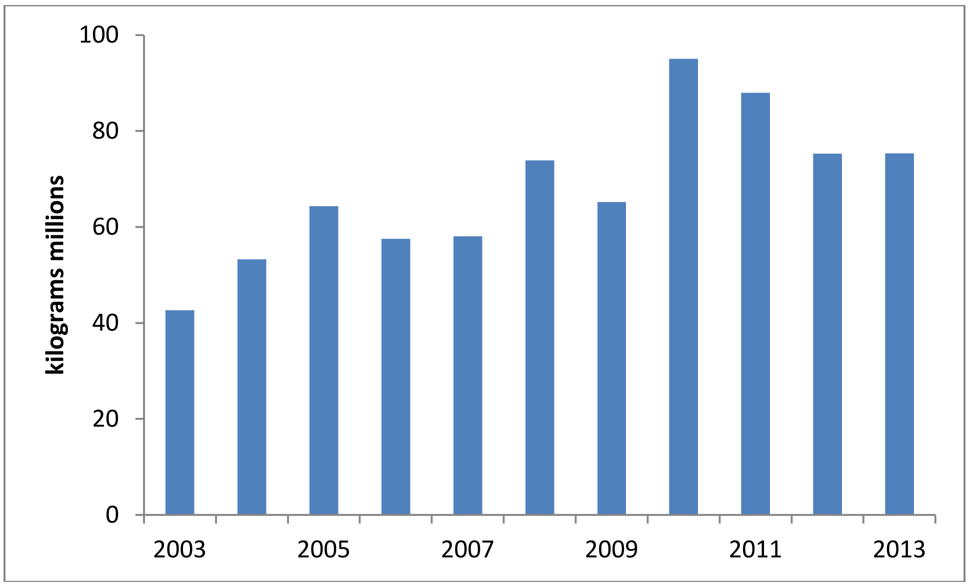
Figure 9: Pharmaceutical Industry in China: No. of Enterprises and Average Employees per Enterprise



Source: China National Bureau of Statistics & YYTJ, via CEIC data.

China's pharmaceutical industry is facing several challenges. As it tries to sell medicine at subsidized rates to the domestic population, China is also trying to overcome high entry barriers in more lucrative markets such as the United States, where there are fewer price controls, but the Food and Drug Administration tightly regulates imports, and the world's leading drug companies are already well-established. It also remains unclear, given cost increases in China, how competitive Chinese pharmaceuticals companies can remain in markets for generic products. Vitamin C exports, for instance, have declined over the past two years (see figure 10).[§]

Figure 10: China's Vitamin C Exports through October
(YTD, kilograms millions)



Source: China General Administration of Customs, via CEIC data.

Perhaps the biggest opportunity for drug sales is China's changing demography. The aging population, rising middle class, and modernizing healthcare sector are increasing demand for healthcare goods and services. The Chinese Communist Party's Third Plenum in November 2013 pledged to modernize the healthcare sector and to integrate rural and urban medical insurance, a policy innovation that could raise demand for pharmaceuticals. However, the world's top pharmaceutical companies from Europe and the United States are clamoring to enter China's domestic market. The government's stance on letting foreign companies into the domestic market has been ambivalent. The November 2013 Third Plenum Decision pledged to open medical care to more foreign investment. On the other hand, foreign pharmaceutical companies over the summer faced government investigations for alleged bribery and price-fixing.[**]

[§] In 2012, there was a major antirust ruling in U.S. District Court against Chinese Vitamin C manufacturers. They were convicted of colluding to set prices even though the Chinese government testified that it had ordered them to set prices. This may have contributed to the decline in Vitamin C exports.

[**] According to Bloomberg: "In July, Chinese investigators accused GlaxoSmithKline Plc (GSK) of using cash and sexual favors to bribe doctors and health officials to promote sales, and said they were expanding their probe to other foreign drugmakers. Sanofi (SAN), Eli Lilly & Co. and Novartis AG have since been ensnared in the scandal, sometimes through accusations leveled in the Chinese media. Johnson & Johnson (JNJ), the world's biggest maker of health-care products, was last month ordered to pay 530,000 yuan in compensation to a distributor after a

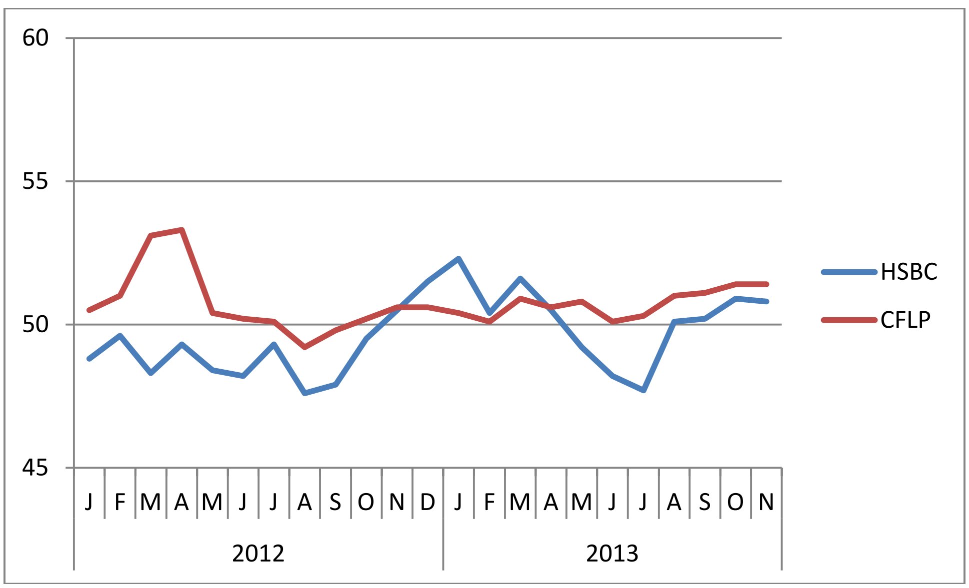
China's Economy

Moderate Recovery

China's economic indicators were stable in October and November, suggesting no major surprises for fourth-quarter GDP growth, to be announced in a month's time. The *Economist* forecasts 7.5 percent growth for the year.[24] Although that number perfectly matches the Chinese government's growth target under the 12th Five-Year Plan, if growth continues to decelerate next year, it will be below the government target.

China's output figures present a mixed picture. Since August, industrial output has rebounded to the double-digit growth rates that were common before 2012. Year-to-date, however, output has grown by just 9.7 percent, versus 10 percent last year, and an average of 14.8 percent over the past decade.[††] Meanwhile, China's purchasing managers' index showed moderate expansion of output and orders, continuing a trend that began in the summer; the HSBC and CFLP indexes, which use different sampling methods,[‡‡] have been converging, indicating a broad consensus among companies about the improved outlook (see figure 11).

Figure 11: Purchasing Managers' Index through November 2013: HSBC and CFLP PMI compared
(<50 = contraction, >50 = expansion)



Source: China's National Bureau of Statistics, via CEIC data; HSBC Purchasing Managers' Index. http://www.hsbc.com/1/2/emerging-markets/em-index/purchasing-managers-index.

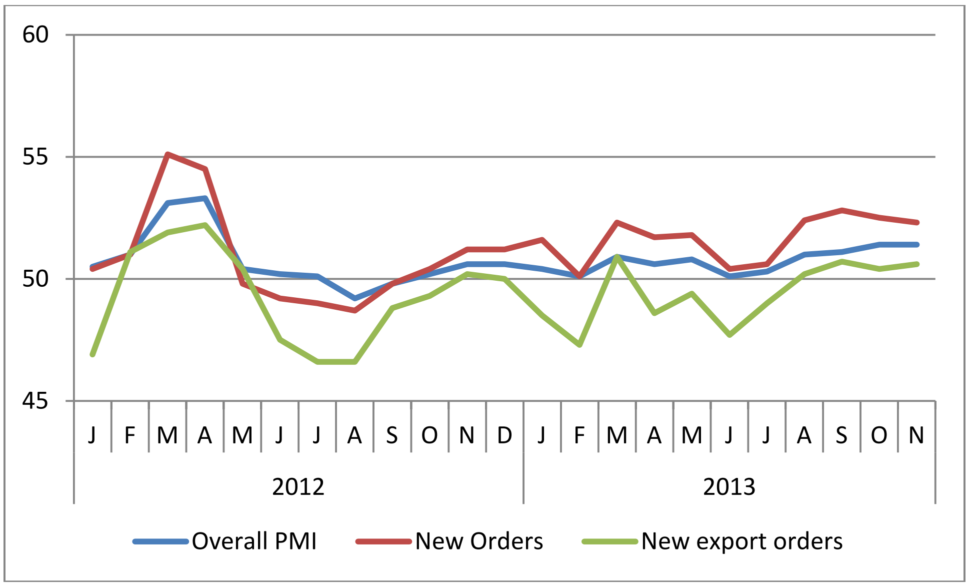
Shanghai court found two of its units guilty of monopolistic practices." Bloomberg, "China-Style Obamacare for 1 Billion People Saves Toddler," September 10, 2013, via Factiva.

†† Figures from China National Bureau of Statistics, via CEIC data.

‡‡ The Hong Kong bank HSBC and the Chinese Federation of Logistics and Purchasing (CFLP) publish separate PMI reports on a monthly basis. HSBC's PMI is seasonally adjusted and more carefully weighted, as well as more independent from government interference, which makes it more credible to many experts. But CFLP surveys more companies, especially state-owned enterprises. The two PMIs tend to produce slightly different results.

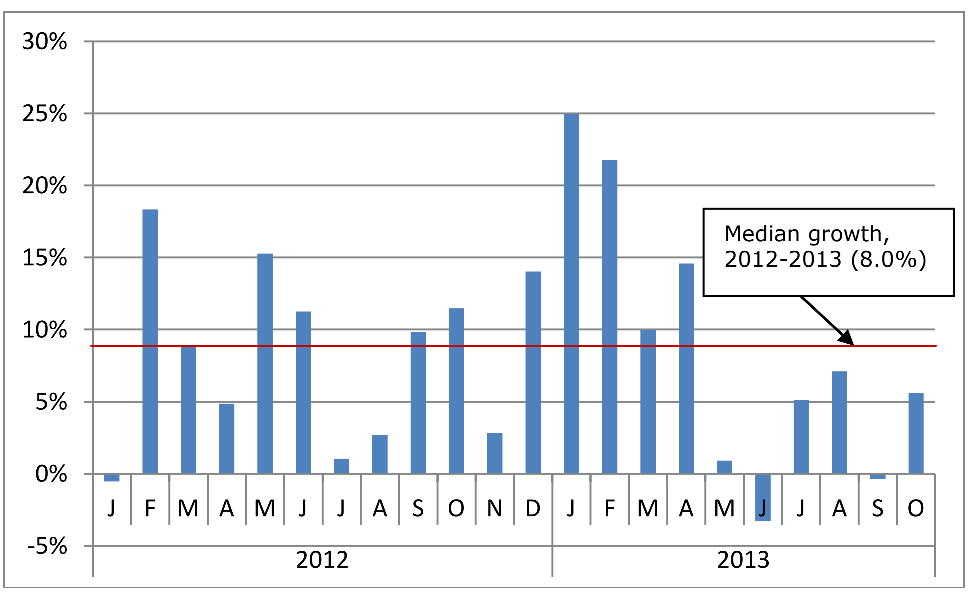
In the CFLP index, producers have indicated an expansion in new export orders since August (see figure 12). However, export growth has been fickle. While growth in July and August was better than in 2012, this trend has since reversed, and in September, exports actually declined by 0.4 percent year-on-year, surprising many analysts (see figure 13). At 7.8 percent through October, cumulative exports in 2013 are virtually unchanged from last year, and well below the 22 percent rate of 2011.

Figure 12: CFLP Purchasing Managers' Index through November 2013: New Orders
(<50 = contraction, >50 = expansion)



Source: China's National Bureau of Statistics, via CEIC data.

Figure 13: Monthly Growth in China's Exports
(Monthly, year-on-year, %)

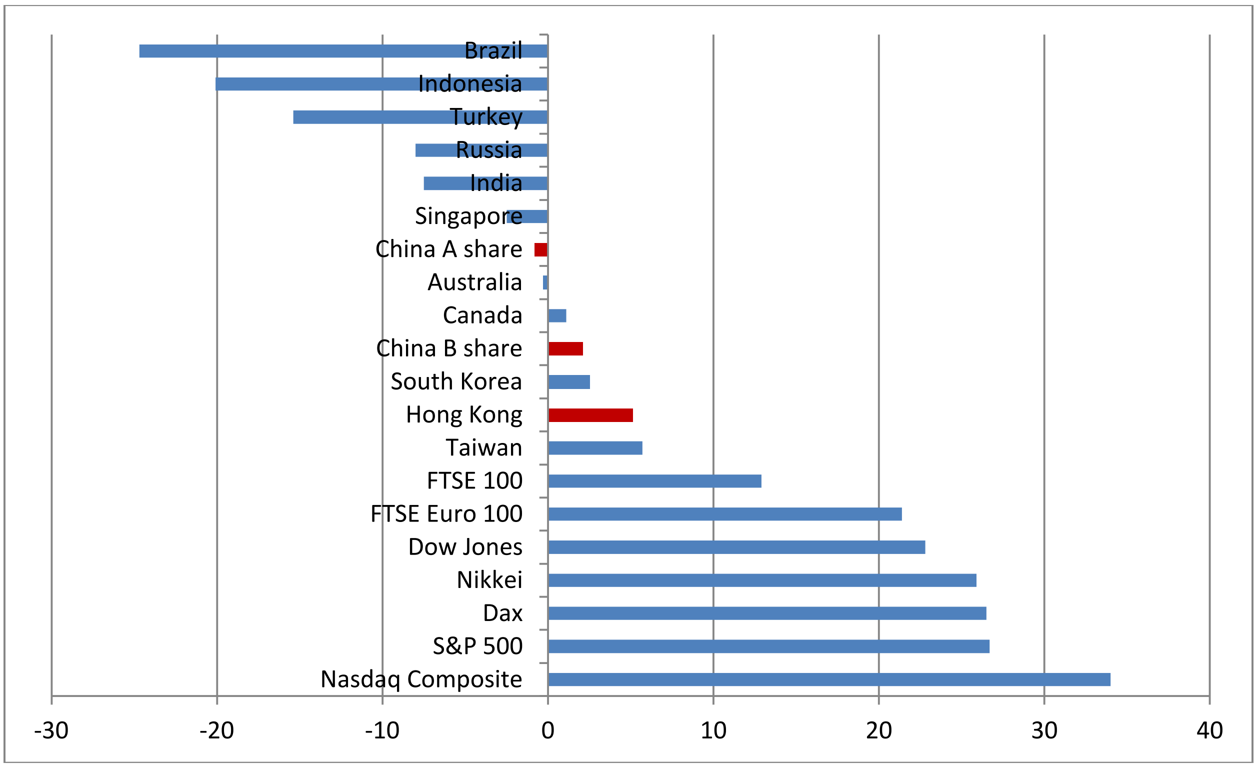


Source: China General Administration of Customs, via CEIC data.

External Balances Continue to Rise

In spite of inconsistent exports, China's central bank is adding to its foreign exchange reserves, which are fast approaching $3.7 trillion. RMB positions at Chinese financial institutions accumulated from foreign-exchange purchases, a gauge of capital inflows, rose in September by the most in five months.[25] Investors appear to remain confident that China's currency will appreciate, and that the world's fastest-growing major economy still is a good option in a global economy undergoing recession. China's stock markets have been unusually steady this year. While most advanced economies' stock markets saw double-digit increases, and large emerging markets witnessed double-digit declines, China's A share and B share markets remained largely unchanged, and the Hong Kong index grew by 5.1 percent (see figure 14). Although China's stock markets are underperforming, they have not been as susceptible to global investment cycles.

Figure 14: Performance of Stock Exchanges, December 31, 2012 to November 27, 2013
(Change, year-on-year, %)



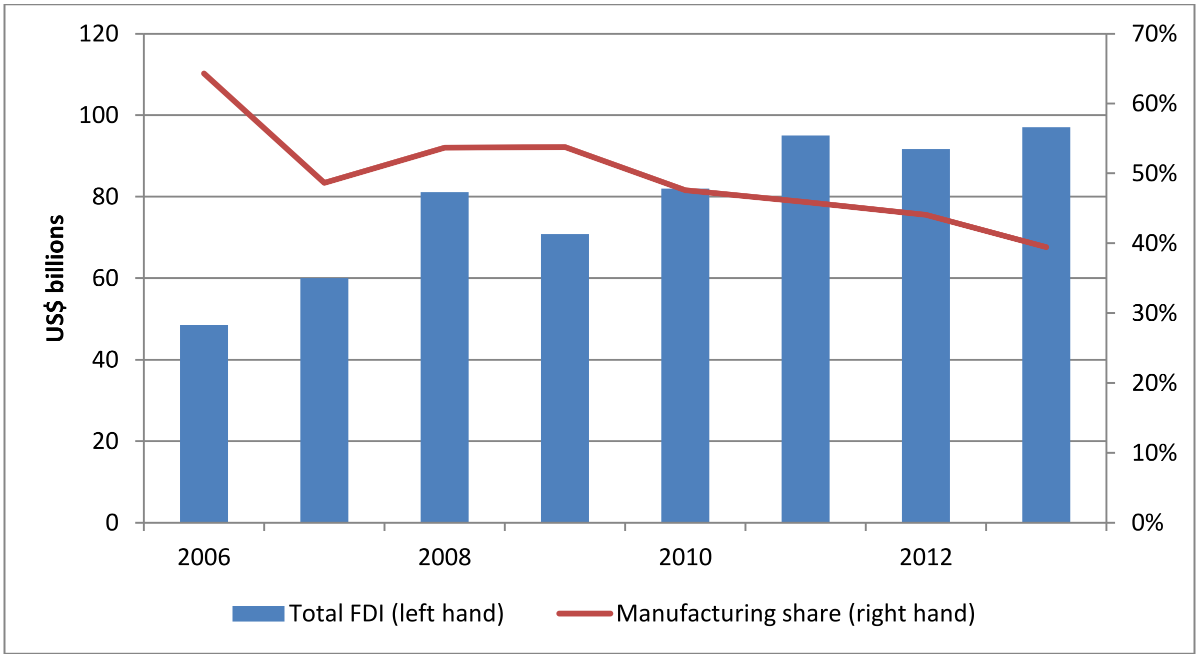
Source: Economist, "Markets," November 30, 2013, p.89.

Investor confidence was likely bolstered by news, issued on December 3, that China's RMB has overtaken the euro to become the second-most used currency in global trade finance in 2013, according to the Society for Worldwide Interbank Financial Telecommunication. RMB deposits in Hong Kong, the largest pool outside China, rose the most since April 2011 to a record 782 billion RMB ($128 billion) in October. Agreements were announced this quarter to start direct currency trading between the RMB and both the British pound and Singapore dollar.[26]

Another factor influencing currency inflows is foreign investment. After a slump in 2012, FDI has returned to the level of 2011, as China attracted $97 billion in FDI in the first 10 months of the year (see figure 15). Most of the FDI growth came in the second half of the year; cumulative growth through October was 4.5 percent, versus just 1.6 percent through

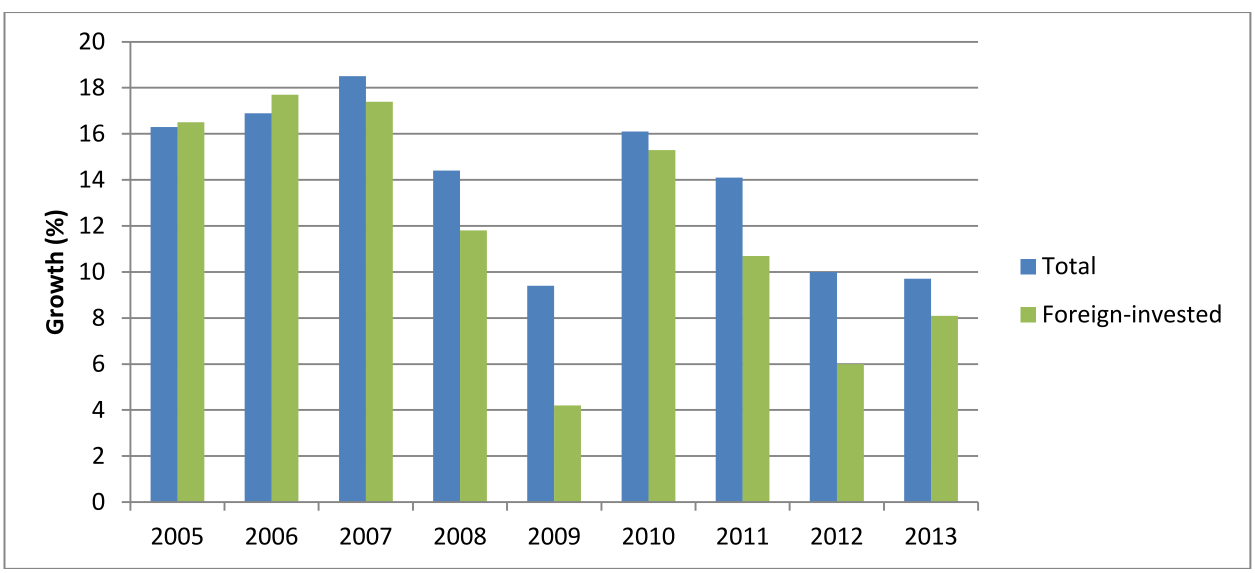
June. Counter to the deceleration of China's industrial output this year, foreign-invested enterprises have actually accelerated their output (see figure 16). Even more important than manufacturing has been FDI in services, as the manufacturing share of FDI has dropped by 5 percent so far this year.

Figure 15: Cumulative FDI into China through October 2013
(US$ billions, share %)



Source: China Ministry of Commerce, via CEIC data.

Figure 16: Growth in Industrial Output to October 2013: Total vs. Foreign-Invested Enterprises
(YTD, year-on-year, %)



Source: China's National Bureau of Statistics, via CEIC data.

Potential for Financial Instability and Housing Bubbles

Debt is perhaps the most significant risk for China's economy. According to a November 19 Bloomberg report, China's largest banks tripled the amount of bad loans they wrote off in the first half of this year, but may still be facing a "fresh wave of defaults". According to an analyst at Standard & Poor's, the primary source of defaults will be industries with excess capacity, such as producers of steel, non-ferrous metals, ships, cement, and solar panels. The government issued decrees over the summer to shed capacity in these industries. China's largest solar panel manufacturer officially declared bankruptcy this fall, and more companies are to follow, potentially including Rongsheng, China's largest shipbuilder. [27] Local government financing vehicles, which borrow funds on behalf of local governments to invest in infrastructure and lend to local producers, owed $1.6 trillion in debts through June, equal to about 13 percent of all bank loans in China.[28] According to estimates by Fitch Ratings, interest owed by borrowers rose to an estimated 12.5 percent of China's economy from 7 percent in 2008, and may climb to as much as 22 percent by the end of 2017, which would "ultimately overwhelm borrowers."[29] Two provincial banks, the Bank of Chongqing and Huishang Bank of Anhui province, are also finding it difficult to raise capital for their Hong Kong IPOs due to investors' concerns about their outstanding loans. [30]

A related risk facing China's financial sector is its housing bubble. Economist Nouriel Roubini warned in a November 29 op-ed that a new wave of housing bubbles is sweeping across 17 major economies.[§§] In a separate analysis, Roubini argued that China, in spite of its vast housing needs, is overinvesting in housing. He presented a series of facts to make his case: China now invests about 9.5 percent of its annual GDP in residential real estate, a ratio only rivaled by Spain in the lead-up to the global financial crisis; China currently produces 57 percent of the world's cement and 47 percent of its steel; 60 of the tallest 100 buildings under construction around the world are located in China; China's incremental capital-output ratio (ICOR)—the number of investment units needed to generate one unit of GDP—rose to 6.3 in 2012 from an average of 3.8 in the five years to 2008, suggesting a 40 percent decline in investment productivity.[31]

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